CORPORATE GOVERNANCE IN THE GCC

By Dr. Nasser Saidi and Rakhi Kumar*

The economies of the Gulf Cooperation Council (GCC) countries are diversifying and continue to grow strongly. Real GDP in the GCC region expanded by some 7½ percent during 2006 and growth is expected to continue at similar rates into 2007. Nominal GDP, credit and broad money annual growth rates have been in the range of 20% to 30%. These above trend average real GDP growth at 7.4% (over 2003-2005), compared to a disappointing decade in the 'roaring 1990s' (2.5% growth in 1998-2002) where the GCC economies failed to become globally integrated.

Importantly, the GCC's growth resurgence has been investment driven with increased infrastructure investment by governments accompanied by complementary private sector investment. Moreover, infrastructure investments estimated in excess of USD 1.3 trillion are planned or under development in the GCC & Iran, leading to a substantial increase in the investment ratio. As a result there is an increase in absorptive capacity and a rise in productivity growth. Moreover, the private sector is leading and driving regional economic integration in the areas of trade, services, tourism and FDI, with GCC companies – e.g. DP, EMAAR, Etisalat, and MTC – investing in cross-border mergers & acquisitions and becoming multinationals.

Growth and abundant liquidity have fuelled a spectacular resurgence of the credit and equity markets. Stock markets grew more rapidly than the economies: market capitalization jumped from an average of some 65% of GDP in the GCC countries to 145% of GDP between 2002 and 2005, with the GCC markets out performing emerging and developed markets. Participation in the markets increased along with strong IPO activity and rising trading volumes on the regional exchanges. Market capitalization grew from less than $200 billion in 2002 to about $1 trillion by early 2006. However, the leading stock markets in the region soon began experiencing corrections on a massive scale (Saudi Arabia 64 percent, Abu Dhabi 37 percent, and Qatar 39 percent). Now that more than a year has passed since the corrections began, P/E ratios and other parameters appear more reasonable (January 2007 P/E ratios are approximately 15, 14 and 15 for Saudi Arabia, UAE and Qatar vs. 40, 26, and 28 in 2005), there are concerns that the process may still have not fully run its course.

As a result of the uncertainty and volatility that has characterized the region's equity markets (see Chart 1), corporate governance has become an increasingly important factor when assessing the investment climate in the GCC. The year 2006 represented a watershed year for corporate governance in the region as policy-makers and regulators contemplated introducing measures to improve corporate governance in listed companies. The next two years will see regulators and companies grappling with changing governance structures and board practices to comply with new corporate governance

*Nasser Saidi is the Executive Director of the Hawkamah Institute for Corporate Governance, DIFC, Dubai, Rakhi Kumar is Corporate Governance Advisory, Institute of International Finance, Washington D.C.. The analysis and views are those of the authors and do not necessarily reflect the views or policies of their respective institutions.

requirements put in place in the previous years. As equity markets in the GCC mature and become increasingly integrated with the global economy, both domestic and foreign investors are requesting higher standards of transparency and disclosure standards.

Moreover, they are demanding that GCC companies comply with the global corporate governance standards that are expected from companies in other emerging markets. Evaluating GCC companies with the same yardstick used in other emerging markets will help to create a pull for better corporate governance and provide GCC companies with an incentive to invest in adopting better standards.

The OECD Principle of Corporate Governance first endorsed by OECD ministers in 1999, are intended to assist OECD and non-OECD governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries[1]. Over the years, several institutions have developed their own set of codes and principles like the Institute of International Finance's Policies of Corporate Governance and Transparency in Emerging Markets[2], which established a code based on criteria that are considered important to international investors.

Both the OECD principles and the IIF Code broadly assess five elements of corporate governance: (1) minority shareholder protection; (2) responsibilities of the board of directors; (3) accounting and auditing; (4) transparency of ownership and control; and (5) the regulatory environment. The OECD has issued a revised set of Principles of Corporate Governance[3] aiming to provide a framework for sound corporate governance. The Principles cover: (1) ensuring the basis for an effective corporate governance framework; (2) rights of shareholders and key ownership functions; (3) equitable treatment of shareholders; (4) role of stakeholders; (5) disclosure and transparency; and (6) responsibilities of the board.

[1] http://www.oecd.org/document/49/0,2340,en_2649_34813_31530865_1_1_1_1,00.html
[2] http://www.iif.com/emr/corpgov/code/
[3] See the OECD principles and discussion thereof:
http://www.oecd.org/document/56/0,2340,en_2649_34813_31530865_1_1_1_1,00.html

Global Corporate Governance Structures

Corporate governance systems and structures vary around the world, with each country having developed standards based on its history and culture. In general, countries either follow the single-tier model of corporate governance found in Board of Directors in the United Kingdom, United States, and other Commonwealth countries or the two-tier model found in many continental European countries such as German, Netherlands and France, and colonies of these countries.

The two systems differ widely in their basic philosophy. Accordingly, control mechanisms in the two systems also differ. A single-tier board structure assumes conflicts of interest between principle parties, which are controlled through a system of outside checks and balances. In contrast, a dual-board structure assumes essentially cooperative relationships, which are controlled through a network of internal contacts between the principle parties.

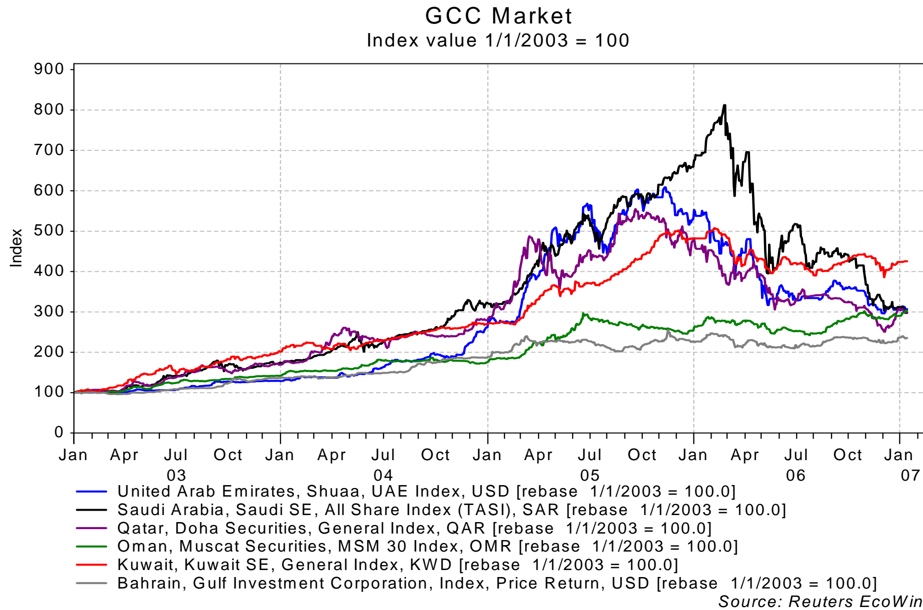
Nevertheless general Corporate Governance principles and standards apply to both corporate board structures.

State of Corporate Governance in the GCC

The corporate governance frameworks, as embodied in a country's laws and regulatory structure and institutions, in the six GCC countries differed widely and were are at different stages of development. The Hawkamah-IIF Comparative Survey of Corporate Governance in the Gulf Cooperation Council report[4] found that Oman, followed by Saudi Arabia and Kuwait had comparatively better corporate governance frameworks than Bahrain, Qatar and the United Arab Emirates. Four factors have contributed to the lack of development of corporate governance in the GCC include:

- Isolation from the global economy
- Large and competitive regional banking network that till now could meet the liquidity needs of most GCC companies
- Dominance of family-owned enterprises that have traditionally relied on internal sources of finance
- Underdeveloped capital markets with weak regulatory environments and the lack of equity culture among investors (Table 1)

Charts 1: stock market volatility in the middle-east



[4] Comparative Survey of Corporate Governance in the Gulf Cooperation Council – An Investor Perspective jointly conducted and published by Hawkamah, The Institute for Corporate Governance and The Institute of International Finance, November 2006

Table 1- Equity Market Capitalization and Concentration

	Market Capitalization as percentage of GDP (Jan 2007)	Market Capitalization as percentage of GDP (July 2006)
Bahrain	133%	126%
Kuwait	138%	154%
Oman	35%	38%
Qatar	128%	175%
Saudi Arabia	78%	140%
UAE-Abu Dhabi/dubai	80%	106%

Sources: Zawya, IMF

Corporate governance frameworks in the GCC are expected to improve in the near-term as countries amend existing company laws, strengthen accounting frameworks by incorporating International Financial Reporting Standards (IFRS), and introduce corporate governance requirements for companies. However, the 'upgrade' of laws, regulations and listing requirements will need to be underpinned by effective monitoring and compliance. Regulators should require mandatory compliance with corporate governance-related laws, strengthen enforcement, and build a strong equity culture, in order to improve corporate governance practices in GCC companies. An overview of the corporate governance environment in each of the GCC countries and country-specific recommendations for improvement made in the Hawkamah-IIF Survey of GCC country reports are provided below:

Bahrain

Substantial efforts are being made to improve the country's overall corporate governance framework. The Ministry of Industry and Commerce (MOIC) has drafted a new Commercial Companies Law, which incorporates numerous corporate governance requirements. The Central Bank of Bahrain (CBB), which regulates the capital market, is reviewing new corporate governance-related requirements for listed companies and the new Commercial Companies Law, which if enacted and enforced would imply a substantial strengthening of the corporate governance regime. Moreover, a public-private partnership, the Bahrain Transparency Association, an alliance of various market participants including, lawyers, accountants, academics and government representatives, has been working over the past few years to improve Bahrain's corporate governance framework. Nevertheless, the government can institutionalize corporate governance best practices by:

- Introducing a code of corporate governance and other related laws that will strengthen Bahrain's corporate governance framework for all listed companies
- Enacting the new Commercial Companies Law

- Focusing on improved practices in state-owned and family-owned companies

Kuwait

The country has strong laws protecting minority shareholder rights; however, the overall regulatory environment in the country requires reinforcement. Improvements to Kuwait's Commercial Companies Law were made following the financial scandal in the 1980s. Nevertheless, since then laws have not been updated. Efforts are under way by regulators to amend the existing Commercial Companies Law and to include corporate governance-related requirements in the new Capital Markets Law. Importantly, Kuwait has an effective court system, with a well regarded judicial system that can support effective enforcement of a strengthened corporate governance regime. Judges are independent and well versed in laws. Moreover, verdicts are provided in a timely manner.

Changes in Kuwait's corporate governance practices have not kept pace with the growth of its equity markets. Two big initiatives currently underway involve establishing an independent capital market authority and legislating corporate governance-related requirements. These initiatives so far have proceeded slowly to the detriment of investors in Kuwait. The Hawkamah-IIF Corporate Governance survey report recommends that Kuwaiti authorities consider introducing corporate governance requirements by amending listing rules while awaiting legislative approval of new laws. This would help prevent Kuwait from falling behind other GCC nations in improving its corporate governance environment. Irrespective of the method adopted, implementing change in the country's corporate governance regime will need the strong backing of the government, which at present seems to be lacking. The government should also invest in broad-based initiatives that will strengthen Kuwait's equity culture. These include:

- Providing educational training to regulatory staff
- Requiring board members to participate in director training programs to develop a pool of trained independent directors
- Establishing an association of accountants who can spearhead development of accounting practices and regulations in the region
- Promoting shareholder activism in the country through those who can take up corporate governance-related causes as significant shareholders
- Introducing ethics and corporate governance in business school curriculums to create awareness and educate future business leaders on best practices

Oman

Oman is the first country in the GCC to adopt a code of corporate governance in 2002 and also the first country in the GCC to establish an independent capital market regulator. The Capital Market Authority began reassessing current corporate governance requirements in fall 2006. Authorities are also considering privatization of Muscat

Securities Market. Nevertheless, weaknesses still exists in Oman's corporate governance framework, and the quality of surveillance and enforcement by the Capital Market Authority and the Muscat Securities Market needs to be reinforced. Some of the specific changes recommended in the Hawkamah-IIF report on Oman that would strengthen the country's existing corporate governance framework include:

- Introducing cumulative voting in director elections
- Establishing a trigger that will instigate a public offer when ownership exceeds 35 percent
- Introducing rules regarding share buybacks
- Requiring the board to create compensation and nomination committees
- Requiring board members to abstain from voting if they have a conflict of interest pertaining to the matter being considered
- Introducing disclosure requirements for off-balance-sheet transactions in the annual report
- Requiring audit committees to address business risks facing the company in the annual report to shareholders

Qatar

The corporate governance framework in Qatar is emerging and is expected to improve in the near term as authorities take steps to improve corporate governance practices in listed companies. In addition, the regulatory environment in Qatar is currently being restructured to strengthen surveillance and enforcement functions. At the end of 2005, authorities established an independent regulator – the Qatar Financial Markets Authority (QFMA) – prior to which surveillance and enforcement functions were carried out by the Doha Securities Market. If government authorities in Qatar wish to enhance the investment climate of the country, significant time and effort needs to be invested in improving the country's rudimentary corporate governance framework. While some changes are underway, authorities need to provide more clarity about the improvements being considered to the existing corporate governance framework.

The Hawkamah-IIF survey recommends that the authorities create a Qatar Corporate Governance Task Force composed of representatives from the various government departments that are responsible for corporate governance to jointly address the deficiencies in the country's current corporate governance framework. In addition, representatives from the business community such as accountants, lawyers, investors and leading private businesses, should also be included in the Task Force. This will help encourage the buy-ins needed to implement the recommendations of the Task Force. The mandate of the Task Force would include:

- Coordinating the efforts of the various government organizations that are responsible for the corporate governance framework in Qatar
- Reviewing the overall corporate governance framework of the country

- Developing a plan to strengthen the current corporate governance framework by addressing deficiencies identified in the Hawkamah-IIF reports such as:
  - Applying "One-share, one-vote" principle universally among shareholders, irrespective of the number of shares they own
  - Requiring shareholder approval for capital changes, ie. takeovers, mergers, buyouts, and capital increases
  - Defining "independent" and "non-executive" director
  - Requiring independent and non-executive directors to be elected to the board
  - Requiring the establishment of audit, nomination and compensation committees
  - Assigning the audit committee the responsibility to monitor risk factors
  - Improving financial disclosure and transparency requirements
  - Strengthening enforcement

Saudi Arabia

Saudi Arabia introduced a code of corporate governance in November 2006 which is broadly in line with international standards. This new code has significantly strengthened the country's corporate governance framework. However, compliance with the code is optional and no deadline for compliance has been set. Therefore, while authorities have improved the corporate governance frameworks of the country they have to manage expectations for compliance with the new laws. Reforms are needed in Saudi Arabia to increase transparency and disclosure and improve the investment climate. Capital markets in Saudi Arabia have been slow to open up to non-Saudi nationals. Meaningful changes in the country's corporate governance environment will depend importantly on the authorities integrating the Saudi capital markets with other GCC and global financial markets.

The Hawkamah-IIF report recommends the following items to further strengthen the corporate governance in the country:

- Open equity markets to foreign investors
- Require large companies to hold regular board meetings at least every quarter and audit committee meetings at least every six months
- Require that the quorum for board meetings consist of executive, non-executive and independent, non-executive members
- Require companies to have an investor relations program and issue statements on environmental issues and social responsibilities
- Promote shareholder activism in the country through those who can take up corporate governance-related causes as significant shareholders
- Require board members to participate in director training programs to develop a

pool of trained independent directors

- Introduce ethics and corporate governance courses in business school curriculums to create awareness and educate future business leaders on best practices

United Arab Emirates

The UAE's corporate governance framework is laid out in the UAE company law that applies to all companies incorporated in the UAE and in the listing requirements of the Abu Dhabi Securities Market (ADSM) and the Dubai Financial Market (DFM). The Emirates Securities and Commodities Authority (ESCA) regulates capital markets in both Abu Dhabi and Dubai. The corporate governance frameworks of Abu Dhabi and Dubai listed companies require modernisation and reform. However, ESCA, ADSM and DFM plan on introducing their own codes of corporate governance for listed companies, which should improve the UAE's overall corporate governance framework. Nevertheless, much needs to be done by way of addressing the weak corporate governance framework and regulatory structure of the country. The Hawkamah-IIF survey recommends the following action plan to strengthen corporate governance in the UAE:

- Increase compliance of UAE's corporate governance framework with international guidelines by introducing a code of corporate governance and making compliance mandatory for all listed companies
- Strengthen ESCA as a capital market authority making it fully independent
- Address weaknesses in the legal framework identified in the report such as introducing cumulative voting in director elections and requiring shareholder approval for mergers and major asset transactions such as takeovers
- Harmonize rules and regulation between Abu Dhabi and Dubai to allow for cross-listing of shares in the short-term, with a medium-term objective of unifying the two exchanges
- Strengthen surveillance and enforcement functions at the stock exchange and regulator level
- Introduce a compatible information platform between ESCA and the stock exchanges to allow for easy exchange of data
- Introduce sector specific reforms to improve corporate governance practices in state-owned and family-owned businesses
- Adopt IFRS as an accounting standard for the corporate sector
- Establish an association of accountants or other mechanisms that can spearhead development of accounting practices and regulations in the country
- Invest in building a good corporate governance infrastructure that will strengthen the equity culture by:
    - Establishing director training institutes
    - Promoting shareholder activism
    - Encouraging business schools to provide management training and

promote business ethics

- Training journalists in financial and investigative reporting

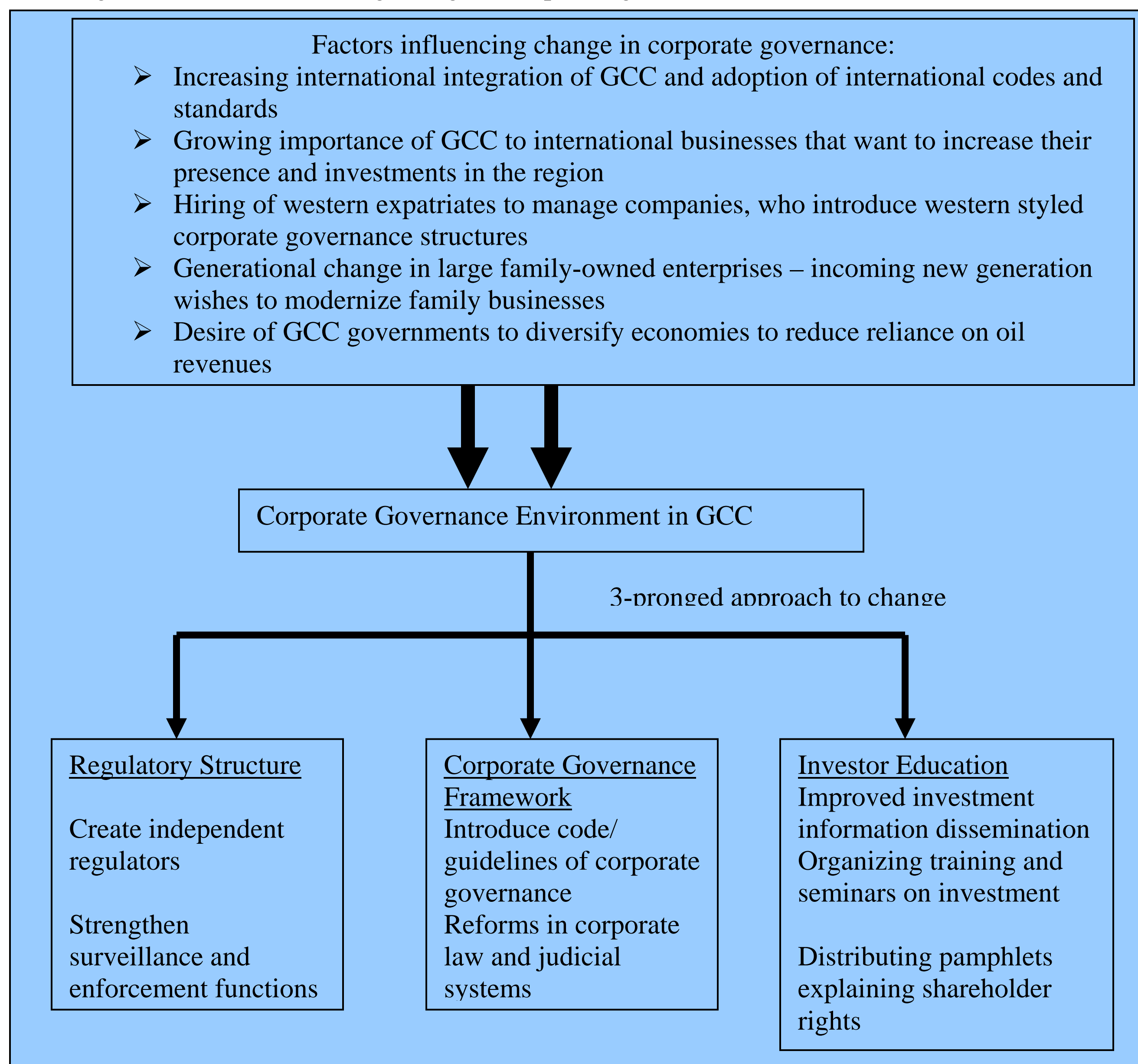
A Changing Environment

The increasing openness and integration of the GCC countries with the global economy has created push-and-pull factors that are contributing to changing the corporate governance environment. Policy and regulatory reforms in the GCC have been led by international convergence and adoption of prudential and regulatory codes and standards, such as Anti-Money Laundering and Counter-Terrorist Financing (AML/CTF), Basel banking supervision core principles, and international obligations and agreements resulting from entry into the WTO, Regional trade Agreements (RTAs) and Free Trade Agreements (FTAs). This has been reinforced by competitive pressure and emulation within the countries of the GCC. Moreover, international institutions, such as the IMF, World Bank, WTO and the BIS have played a role in providing technical assistance and building knowledge and capacity.

There is also increased pressure for change resulting from globalisation, liberalisation and the inter-connectedness of markets. Change is also being driven by regional/ international investors, including the growing presence of international firms in the region, and larger number of western expatriates in senior management level positions, who themselves are subject to global corporate standards.

Most governments in the GCC have adopted a three-pronged approach to strengthening corporate governance in their countries that focuses on (i) Regulatory Structure, (ii) Corporate Governance Framework and (iii) Investor Education. The interplay between factors affecting change in the region's corporate governance environment and methods employed by regional authorities is explained and illustrated in Figure 1.

Figure 1 Factors influencing change in corporate governance



Need for targeted reforms in Family-Owned Enterprises (FOEs)

A three-pronged approach, as noted above, while effective for listed companies, fails to address corporate governance weaknesses in non-listed companies. Family-owned enterprises (FOEs) constitute more than 85% of non-listed companies in the GCC. In general, compared to global corporate governance standards, these companies have weak corporate governance practices and are reluctant to change the 'old' ways of doing business. Their resistance can be attributed to:

- Fear of loss of control by family
- Fear that increased transparency and disclosure will reduce competitive advantage of business
- Fear of change fuelled by a lack of understanding of 'new' corporate governance practices

- Failure to recognize the benefits of good corporate governance practices, in ensuring successful succession planning, higher equity valuations, access to external sources of capital and finance, improved credit ratings, better terms and conditions of finance

Nevertheless, if equity markets are to deepen in the GCC, it is important for authorities to introduce incentives and corporate governance reforms aimed at FOEs. Many non-listed FOEs in the region are sizable enough to list on a stock exchange. However, due to inadequate corporate governance standards these companies will not receive valuations that would adequately compensate them for the loss of the family's control and increased compliance costs. Introducing reforms that specifically address weaknesses in the FOE governance structure will help bring corporate governance practices of these companies more in line with current best practices. Moreover, reducing the gap between current practices and corporate governance requirements incorporated in listing rules of stock exchanges will make it easier for non-listed companies to list on stock exchanges in the future. In particular, the introduction of two-tier stock exchanges or 'alternative investment markets' with listing requirements designed to attract FOEs and SMEs can be an important structural change encouraging IPOs.

Targeted reforms for family-owned enterprises include:

- Reforming company boards by increasing overall board independence and reducing the number of family members or requiring FOEs to establish advisory board of directors
- Limiting role of family members in senior management
- Increasing transparency of ownership structures and related-party transactions
- Requiring FOEs to submit audited financial reports to authorities
- Other mechanisms that FOEs should be encouraged to adopt include creating family councils and family charters that deal with family disputes and establishing guidelines for hiring family members into the business

<u>Role of the Banking System in cascading change</u>[5]

The banking sector in the GCC is well-developed (Table 2) and banks continue to be the primary provider of funds to businesses. Over the past three years, banks and financial institutions in the GCC have significantly improved internal corporate governance practices. Progress has been achieved in the corporate governance of the banking sector in the GCC countries, by complying with the BIS Core Principles for Effective Banking Supervision and related prudential and regulatory measures. Moreover, instituting effective bank supervision authorities, as well as acting to ensure market integrity through anti-money laundering and counter terrorist financing legislation and instituting AML/CTF commissions has also helped strengthen corporate governance in GCC banks.

[5] For further discussion, see N. Saidi (2006), "Improving Bank Corporate Governance in the Arab Countries", published in Arab Bank Review, http://www.arabbank.com/ABDATA/review/vol7_no2/Review_Oct_05.pdf

A recent survey of the financial systems in the MENA countries by the IMF[6] provides evidence that MENA bank regulatory authority practices are in line with international best practice and benchmarks, with the GCC countries being the highest rated among the MENA countries. Indicators relating to the regulation and supervision of the banking and financial sector show good performance for the majority of the MENA countries with developed banking sectors such the as the GCC, Lebanon, and Jordan. However, countries with "repressed" financial systems or dominated by state-owned institutions such as Libya, Syria, Iran, and Algeria, show weak governance of the financial sector.

The BIS has recently issued[7] guidance in the form of principles for corporate governance in banking organisations. These principles include guidelines for the role of bank supervisors (see accompanying box), which effectively brings corporate governance within the framework of oversight and supervision of the regulatory authorities. The principles conform to the more general OECD Corporate Governance principles and adapts them to the banking sector. The BIS notes that the *"guidance is not intended to establish a new regulatory framework layered on top of existing national legislation, regulation or codes, but is rather intended to assist banking organisations in enhancing their corporate governance frameworks, and to assist supervisors in assessing the quality of those frameworks"*.

To comply with risk management guidance of the Basel Committee, Central banks across the GCC have revised regulatory requirements. GCC banks are now required to put in place a board-level audit committee, appoint independent directors and establish a risk management system. For example, in Kuwait, audit committees exist only in banks and financial institutions under the supervision of the Central Bank of Kuwait. Banks are also required to obtain prior approval from their central bank before appointing a director. Similarly, banks must provide corporate governance-related information to central banks as part of their annual reporting cycle. Consequently, corporate governance practices in the banking sector are significantly better than those practiced in the non-bank corporate sectors.

---

[6] See Creane S. et al., "Financial Sector Development in the Middle East and North Africa" IMF Working Paper (2004), http://www.imf.org/external/pubs/ft/wp/2004/wp04201.pdf.
[7] See Bank for International Settlements, [Enhancing corporate governance for banking organisations], Basel Committee on Banking Supervision report, bcbs122, February 2006.

Table 2: Asset Size of the Banking Sector Relative to Size of GDP

Country	Commercial Bank Assets to GDP (Dec 2006)
Bahrain*	129%
Kuwait	101%
Oman	49%
Qatar	116%
Saudi Arabia	63%
UAE*	121%

* November data
Sources: Central Banks and Monetary Authorities, IMF

Bank financing continues to be the largest source of external funding for GCC businesses. Most regional banks are controlled directly by families or governments that have strong ties to the business community in the GCC. Name-based lending is prevalent among banks, although most central banks, to minimize default risk in the region, place a limit on the maximum exposure to individual businesses and prudential limits on related party lending. As a result, companies have had little need to rely on equity markets to meeting funding needs and have limited incentive to change corporate governance practices and strengthen minority shareholder rights, which lies at the heart of good corporate governance principles.

Up to now, banks in the region have played a limited role in scrutinizing governance practices of borrowers. Nevertheless, banks could play a larger role in the short-term until authorities strengthen enforcement and surveillance functions at the regulatory level. In Japan and Germany, where conditions are similar to the GCC in that banks provide a large portion of funding to companies, banks play an important role in providing additional oversight on management *(see box on Role of Banks in Providing Corporate Governance Oversight in Japan and German)*. In some instances, bank representatives serve as directors on the board of companies and are privy to strategic discussions. The underlying philosophy to allow bank representation on boards is that banks have a fiduciary responsibility to their depositors and therefore a bank's interest is aligned with interest of minority shareholders. However, this may not always be true. Certain risks exist when banks play a larger role in providing corporate governance oversight and include:

- Excessive credit risk exposure to a since business
- Problems of related-party lending, where banks make loans without adequately assessing underlying risk or charge a higher rate of interest
- Conflicts of interests for banks, who could align their interests with management to get more business
- Weakening of the banking sector and excessive bad debts due to related-party lending.

Nevertheless, banks are important stakeholders in GCC companies and can play a significant role in improving corporate governance practices in borrowing firms by requiring firms to provide governance related information such as:

- Quarter financial reports and audited annual reports
- Names and biographical information regarding board of directors
- Details regarding meeting frequency of board meetings
- Report on risk assessment by the board of directors
- Report on quality of internal controls from the board of directors and/or external auditor
- Board representation if debt covenants are broken

ROLE OF BANKS IN PROVIDING CORPORATE GOVERNANCE OVERSIGHT IN JAPAN AND GERMANY

Japanese and German commercial banks play a central role in the corporate governance models in their countries. The Japanese system is characterized by a network of inter-company equity holdings or keiretsu, with banks at the center of the network. In Japan, main banks own a significant stake in keiretsus and as shareholders, either have or can obtain a seat on the board of directors. In some cases, banks get board representation when cash flow problems become unstable. In the Japanese model there is a degree of co-dependency between banks and keiretsu. Due to complex cross-shareholdings management benefits by insulating itself from takeovers and banks benefit by influencing level of risk taken on by firms, thereby controlling their investment portfolio.

Banks play an even greater role under the German system of corporate governance. German banks have a position of information and power to monitor activities of management and when necessary, discipline management. In general, German banks own a smaller equity stake in companies compared to their Japanese counterparts. However, German banks supplement their voting rights by voting shares owned by the mutual funds they operate.

Source: Corporate Governance and Banking in Germany, Japan and the United States by Jonathan R. Macey
(see: http://www.fed-soc.org/Publications/practicegroupnewsletters/financialservices/fi010101.htm
http://www.newyorkfed.org/research/epr/03v09n1/0304mace.pdf)

Way forward

Interest in corporate governance continues to remain high in the GCC region. However, the time for discussion is over and words now need to be put into action. The recent Dubai Declaration[8] calls on the GCC and MENA countries building on recent efforts "***to continue improving the legal and regulatory framework underpinning corporate governance".*** Further, it requires that ***"parallel to strengthening these frameworks, the capacity of supervisors and regulators should also be addressed".*** Moreover, it says that ***"self-regulatory measures and corporate governance codes should be developed as a complementary mechanism for improving enforcement in the region."***

A strong commitment to better corporate governance from the political authorities as well as from senior government officials involved with capital market development is needed for real change to take effect. Actions that need to be taken can be divided into four basic categories – Structural Reforms, Regulatory Reforms, Transparency and Others. Table 3 provides greater details on the reforms that governments need to pursue in the short and medium-term.

[8] See http://www.hawkamah.org/media_centre/archive/2006/18.html

Table 3: Corporate Governance Reforms Required to Strengthen GCC Equity Markets

STRUCTURAL REFORMS

- Judicial and legal reforms
  - ➢ Establish specialized financial courts to deal with cases pertaining to securities related offences
  - ➢ Revise corporate and securities law to strengthen minority shareholder rights
- Establish rating agencies to help investors assess degree of risk and value of securities.
- Regulate fund managers to tackle problems of:
  - ➢ Front running
  - ➢ Insider trading
- Introduce market pricing mechanism for the IPO market such as book building and rating of IPO securities

REGULATORY REFORMS

- Introduce corporate governance codes on a mandatory compliance basis for all listed companies
- Strengthen surveillance and enforcement functions at the regulatory level by increasing/strengthening prosecution of errant individuals and companies
- Make securities regulatory fully independent like FSA

TRANSPARENCY

- Improve quality of financial disclosure by requiring companies to provide information on a consistent basis including a management analysis of strategy and risks
- Require public disclosure of board of directors and details of frequency of board meeting, pay etc
- Require disclosure of
  - ➢ Related-party transactions
  - ➢ Material information
  - ➢ Ownership structure and shareholdings

OTHER ACTIONS

- Director and investor training programs
- Opening markets to international investors
- Establish shareholder activist group
- Encourage non-GCC national to serve as directors on boards

The GCC countries have a strong interest in investing to promote higher corporate governance standards because good corporate governance is part of the institutional infrastructure (laws, regulations, institutions and enforcement mechanisms) underlying sound economic performance. Better corporate governance is correlated with better operating performance, higher market valuation and lower credit risk of companies. By

preserving and protecting property rights – in particular those of minority and foreign shareholders – it encourages long-term investment in human and physical capital, foreign direct investment, as well as the creation of intellectual property. By stimulating performance, generating higher returns and profitability of companies, it encourages higher total factor productivity growth, which can be a major source of economic growth. By limiting the abuse of power by corporate insiders, it creates an efficient mechanism for transferring wealth between generations. By setting corporate governance standards, monitoring managers of companies and making them accountable for their actions, it protects investors' interests; in turn, this encourages both domestic and foreign direct as well as portfolio investment.

The GCC financial sector must develop the capacity to channel a significant proportion of savings into long-term productive investment. Domestic financial systems and in particular, the banking sector, have undergone important reforms in recent years in order to address this challenge. However, progress has been uneven and related reforms need to be bolder if they are to bring a more modern equity culture. Furthermore, greater competition among sources of financing is needed. GCC financial institutions also need to face the competition of a global business and regulatory environment. Implementing the principles of corporate governance will be a major building block for sound financial markets and banking industry. The stakes are high: better corporate and public governance improves the investment environment and creates better institutions, which enables diversification of economic activity and sustainable economic growth.